



Fiscal Year 2014-15 Boilerplate Report

Public Act (PA) 252 of 2014, Article XV, Section 808

Executive Summary

Within PA 252 of 2014, Article XV, Section 808, the Legislature called upon the Department of Natural Resources (Department) to “develop a lawful and reasonable plan designed to motivate lessees under state-granted oil and gas leases past their primary term to undertake warranted new operations to ensure that department-managed minerals are fully developed in an orderly manner to increase and optimize production.”

The Department’s plan to encourage new exploration of mineral rights on leases past their primary term was developed after consultation with legal counsel.

History

The Department is authorized under Part 5, General Powers and Duties, of the Natural Resources and Environmental Protection Act, 1994 PA 451, as amended, to “enter into contracts for the taking of coal, oil, gas, and other mineral products from state-owned lands, upon a royalty basis or upon another basis, and upon the terms the department considers just and equitable.”

The first oil and gas leases involving state-owned lands in Michigan were issued by the Public Domain Commission and included coal or ore. Three such leases were issued between 1919 and 1920, covering almost 24,000 acres in three different counties. There were 14 oil and gas leases issued by the Conservation Commission between 1921 and 1927, covering almost 450,000 acres of state-owned land, much of which was located in the Upper Peninsula. The acreage included in these leases varied from 40 acres to over 161,000 acres, as there was no limit to the acreage which could be included in a lease. Drilling operations commenced under only two of these leases, and no producing wells were established.

By 1931, all of these leases had expired or had been canceled for failure to comply with the lease provisions. In 1929, the Conservation Commission adopted policies which limited the number of acres per lease to a maximum of 2,560 acres. On October 10, 1980, the Natural Resources Commission approved an Oil and Gas Task Force report, which recommended that the maximum size of an oil and gas lease be reduced to 640 acres. In 1985, the maximum lease size was reduced to one quarter section (usually 160 acres). In 1995, the language allowing rental payments for nonproducing acreage past the primary lease term was eliminated so that nonproducing acreage would be released at the lease expiration date. Out of over 13,000 oil and gas leases covering more than 1.3 million acres, there are less than 150 leases past their primary term, which contain approximately 127,000 acres that is not under production.

Plan

After consultation with legal counsel, it is clear that, as Lessor, the Department has three options to motivate Lessees to take steps to optimize production.

- The first option is to sue the Lessee under the implied covenants of reasonable development and prudent operator and ask a court to order the Lessee to either produce the undeveloped lease acreage or release it. To the Department’s knowledge, there is

currently no case law in Michigan addressing this situation. This would be an expensive and time-consuming undertaking if the Lessee decided to oppose the lawsuit. Language in the State of Michigan Oil and Gas Lease allowing for rental payments in lieu of developing lease acreage past the primary term of the lease was removed in 1995. Less than 10 percent of the acreage currently under an oil and gas lease issued by the Department is nonproducing and tied to a lease beyond its primary term. Based upon these facts, it does not appear prudent to pursue resolution of this issue through the courts.

- The second option is to offer the Lessee some type of incentive to produce the undeveloped acreage. Examples might be a reduced royalty rate for the producing acreage in exchange for release of the nonproducing acreage. Another option could be purchasing the unabated lease rights back from the Lessees. However, the Department does not have funding or authority to offer any incentives to these Lessees at this time.
- Finally, the Department could simply ask the Lessee to produce the undeveloped acreage or release it. Upon review, these Lessees are in compliance with the existing lease terms. With this in mind, the Department's plan is to contact the 15 affected Lessees, requesting details regarding their plans for the undeveloped acreage and asking that they produce or release the acreage within five years.

Conclusion

The oil and gas leasing program in Michigan has been active for almost 100 years. Revenue from the leasing of state-owned oil and gas rights has reached nearly \$2 billion since 1927. The lease contract has evolved over time as industry practices have changed. The current lease contract does not allow for rental payments on nonproducing acres past the primary term of the lease. Current lease practices are reflective of the Department modifying its practices to facilitate greater production of state-owned mineral rights and ensure optimal production and development of hydrocarbons.